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DE RUEHJA #1007/01 1430511
ZNR UUUUU ZZH
R 220511Z MAY 08
FM AMEMBASSY JAKARTA
TO RUEHC/SECSTATE WASHDC 9071
RUEATRS/DEPT OF TREASURY WASHDC
INFO RUEHZS/ASSOCIATION OF SOUTHEAST ASIAN NATIONS
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RUEHKO/AMEMBASSY TOKYO 1998
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UNCLAS SECTION 01 OF 02 JAKARTA 001007

SIPDIS
SENSITIVE

DEPT FOR EAP/MTS AND EB/IFD/OMA
TREASURY FOR IA-SETH SEARLS
COMMERCE FOR 4430/KELLY
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR CURRAN
DEPARTMENT PASS EXIM BANK
SINGAPORE FOR SBAKER
TOKYO FOR MGREWE
USDA/FAS/OA YOST, MILLER, JACKSON
USDA/FAS/OCRA CRIKER, HIGGISTON, RADLER
USDA/FAS/OGA CHAUDRY, DWYER
USTR WEISEL, EHLERS

E.O. 12598: N/A
TAGS: EFIN EINV ECON EAGR ID
SUBJECT: INDONESIA: STRONG FIRST QUARTER GROWTH BUT RISKS MOUNT

REF: A) Jakarta 848 B) Jakarta 871

¶1. (U) Summary. Indonesia's economy grew 6.3% (y-o-y) in response to strong internal and external demand as well as an increase in the rate of investment. Analysts attributed the strong performance in part to the lagged impact of looser monetary policy in 2007. The manufacturing sector recorded modest growth, while the transportation/communication and utilities sectors expanded rapidly. Economists expect inflationary pressure to prompt tighter monetary policy and reduce GDP growth later this year. The outlook for job creation and poverty reduction in 2008 also remains poor. End Summary.

Strong Investment and Exports Support Growth

¶2. (U) Indonesia's first quarter 2008 growth rate was 6.3% (y-o-y), due to strong expansion of exports, investment and domestic demand. After slowing in late 2007, Indonesia's exports rebounded during the first three months of the year due to strong performance in the commodity sector. Exports as a whole rose 15.0% in the first quarter. Palm oil, rubber, and coal exports rose 17.1%, 7.1%, and 7.0% respectively (y-o-y) during the same period. Growth in exports to the European Union, Japan, and the US outpaced other destinations. Investment growth was also strong, surging 13.3% (y-o-y) during the quarter. Analysts attributed the strong investment performance to the lagged effect of looser monetary policy in 2007. Domestic demand remained healthy, increasing 5.5% (y-o-y) over the period and accounting for roughly half of the overall expansion in GDP. Imports continued to increase rapidly, with strong growth in electrical and other mechanical tools. The weakest component of GDP was government spending, which grew only 3.6% (y-o-y) during the quarter.

¶3. (U) Growth across sectors varied widely, with transportation, communication and utilities (electricity, gas, and water) expanding much more rapidly than other sectors. However, utilities contributed little to overall growth, given the limited size of the sector. Agriculture growth expanded rapidly during the first quarter, jumping 6.0% (y-o-y), due to better weather and rising crop prices. Growth in the manufacturing sector improved modestly, at

4.3% (y-o-y), after slowing to 3.8% (y-o-y) in the final quarter of ¶2007. The poorest performing sector was mining, which contracted 2.3% over the previous year.

Inflation Risk Rising

¶4. (U) External sources of inflation are the biggest risks to growth and stability this year. Soaring food prices have already pushed CPI inflation to 9.0% (y-o-y) as of the end of April. The expected continued strength of global prices for imported agricultural commodities, such as soybeans, wheat and rice (imports of rice are forecast toward the end of the year; ref A), will put additional pressure on the CPI. The price of flour in Indonesia continues to soar, rising 13.1% since early January. Rice prices have also begun to climb, increasing 8.3% since the beginning of the year. Market analysts and government officials expect Indonesia's inflation rate to rise above 11% if the government implements its proposed fuel price increase (ref B). HSBC economists predict CPI inflation will soar in the next few months and could hit 15% before the end of the year.

¶5. (SBU) Most market analysts expect the central bank - Bank Indonesia (BI) - to raise interest rates further before the end of the year to control domestic inflation. Government officials have stated that they expect BI to increase rates by at least 250 basis points if the government moves ahead with plans to reduce fuel subsidies. Higher rates are likely to curb investment and domestic demand. Yet, experts do not agree on the extent to which BI should raise rates. Given that a large portion of food and fuel inflation is imported, higher domestic interest rates may not be an effective

tool in fighting inflation in Indonesia. If higher interest rates slow domestic demand and economic growth but fail to control inflation, pressure on poor household budgets will likely mount.

¶6. (U) Other economic analysts argue the food and fuel prices will quickly spread to the broader basket of consumer goods and prompt rapid increases across the board if BI does not act decisively to control inflation. In addition, an increasing number of investors in the region are taking a more cautious approach to Indonesia in advance of the 2009 election, according to market analysts. If the government fails to secure the budget by reducing fuel subsidies, or is slow to fight inflation, investors may begin to lose confidence in Indonesian assets. A reverse in capital flows would weaken the currency and exacerbate imported inflation.

Outlook for Job Creation Weak

¶7. (U) Slower growth and structural inefficiencies mean the outlook for job creation this year remains poor. The open rate of unemployment is roughly 9 percent and Indonesia faces a lingering underemployment problem, particularly in the rural sector. Although the prices of many Indonesian crops have reached historic highs, structural inefficiencies in the agriculture sector impede most farmers from taking advantage of higher food prices. The vast majority of Indonesian small-scale farmers remain net purchasers of food. Other industries are also unlikely to net significant additional jobs this year. High commodity prices rather than higher export volumes drove Indonesia's commodity export performance in recent quarters, due to limited investment in new productive capacity, according to analysts. The value of imports grew 13.2% in 2007, while the volume increased only 4.8%, according to the Central Bureau of Statistics. As a result, potential job creation in the natural resources sector remains limited in the near term, even if commodity prices remain high. Analysts also predict that the labor-intensive manufacturing sector will slow later this year in response to reduced demand from the U.S. and Japan.

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